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The Dangers of Premature LDC Reflation

Rising optimism about the U.S. recovery and the promise of lower oil prices this year may prompt a number of non-oil LDCs to take a second look at how efforts to improve their current-account balances measure up against other economic priorities.

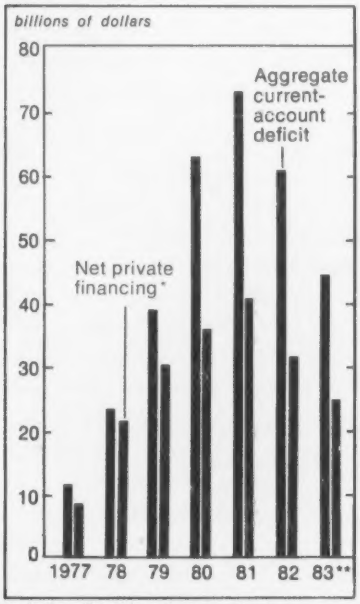
Last year, despite depressed commodity prices, stagnant world trade, and high interest rates, the aggregate current-account deficit of the non-oil LDCs fell some $10-12 billion below the level of 1981. Much of this adjustment, of course, was involuntary, as constraints on external financing depressed domestic expenditures in many countries. This year, the combination of rising commodity prices, lower interest rates, and a modest recovery in OECD economic activity could trim that current-account deficit by another $8-10 billion. And a 10%-15% decline in world oil prices this spring could mean an additional $10 billion improvement through still-lower interest rates and higher OECD imports of raw materials and manufactured goods.

As such improvements appear, there will be intense domestic pressure in many countries to abandon current austerity policies and catch the wave of global recovery. Under such circumstances, are there still dangers of domestic reflation in those non-oil LDCs with relatively large external debts?

Many of the developed countries already know the answer. The OECD nations learned the consequences of "premature" reflation last year—through the discipline imposed by the foreign-exchange and long-term capital markets. In the case of the non-oil LDCs, the taskmasters would include the international banking community and, in the most critical cases, the International Monetary Fund. For, although net private financing of non-oil LDC deficits fell in 1982 (both in absolute amount and as a proportion of total external financing), the decline would have been even more abrupt without collective action to sustain lending to various large debtors. Furthermore, the international capital markets are also likely to be tapped for funds this year by certain oil-exporting countries without the large external reserves of the Arab Gulf states.

Thus, adjustment policies by developing countries—both non-oil and oil-exporting—will remain under scrutiny by the world financial markets during 1983. And a significant improvement in balance sheets will be necessary before international lenders welcome increased expenditures by the non-oil LDCs. After rebuilding reserves, a shift toward expansionary policies would be warranted in 1984.

Financing requirements of the non-oil developing countries



* Including direct investment and net commercial banking flows, both long and short term.

** Forecast

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Lower oil prices could give strong boost to German current-account surplus.

Germany's current account registered a dramatic turnaround last year—to a 7.5-billion DM surplus, after a 16.7-billion DM deficit in 1981. The trade surplus almost doubled to 51 billion DM and the traditional deficit on invisible items, such as insurance, tourism, and transfer payments, declined somewhat. Ironically, export volume, which rose dramatically in 1981, fell throughout most of 1982, but import volume declined even faster. However, the major force behind the current-account reversal was 4.4% improvement in Germany's terms of trade, as the trade-weighted value of the mark rose and commodity prices in foreign-currency terms declined sharply. A further rise in the ratio of export volume relative to import volume is unlikely this year, but additional improvements in the terms of trade—brought on by, among other things, a lower oil price—could lead to a doubling of the current-account surplus. For example, a 10% reduction in the DM price of oil, would add about 7 billion DM to Germany's trade surplus.

Restrictive policies should yield Belgium further improvement in trade balance.

The tough policies introduced one year ago by Belgium's right-of-center coalition government are showing their first positive effects. A year ago, the franc was devalued by 8.5%, and wage indexation was loosened. This resulted in a reduction of about 3% in real wages and a rise in exporters' profit margins. By the third quarter of 1982, export volume showed year-on-year growth of some 1.6% while import volume was down 7.6%. The trade deficit contracted sharply over the course of the year, so that the September-November period showed a trade surplus of some 8 billion francs, compared with a year-earlier deficit of some 17 billion francs. Industrial production has also shown signs of recovery; latest data indicate output in October was some 3.4% above its year-earlier level. This year, the Martens government is aiming for a further 3% cut in real wages, which —combined with some improvement in the Belgian terms of trade—should lead to a further narrowing of the trade gap.

Aborted wage bargaining puts gains of Sweden's October devaluation at risk.

The recent breakdown of Sweden's centralized wage negotiations is threatening to undo the government's strategy for improving international competitiveness and encouraging export-led growth. The government's fiscal 1983/84 budget proposals, announced last month, are clearly designed to reinforce the positive effects of last October's 16% devaluation. Proposed programs focus on curbing domestic demand for imported goods by stemming private consumption and on boosting employment via export growth and stepped-up spending for public- and private-sector investment. But unless Swedish wage increases can be kept in check, the benefits of devaluation will be lost to increased inflation, and the country's export performance and current-account deficit will remain as troublesome as ever. Swedish inflation has persistently been higher than that of its trading partners and has already shown signs of accelerating further. December's 10% year-on-year increase in consumer prices was the largest rise since November 1981. Prime Minister Palme has appealed to both labor and management to remember their "responsibility to the citizens of Sweden" and is expected to exert strong pressures on both sides to get back to the bargaining table.

Papua New Guinea to place more emphasis on private sector.

The economy of Papua New Guinea was disrupted last year by weak demand for cocoa, copra, coffee, and most important, copper. As a result, the government has reconsidered its development priorities. Prime Minister Somare recently indicated what may be a major shift in policy, eschewing the development path followed since independence in 1975. According to Somare, that path centered on excessive government spending and involvement in most development projects—policies which have now proven to be "inappropriate" for Papua New Guinea. The prime minister envisions a smaller government sector, and as a result, about 10% of the public workforce will be cut. New emphasis will be placed on agriculture in hopes that the country can become self-sufficient in food production. Somare, a well-respected Third-World leader, now seems to believe that more dependence on the private sector will produce faster growth than the highly-centralized planning that characterizes many developing economies.

Canadian economy showing signs that it is on the mend.

Signs of an incipient economic recovery in Canada are becoming more evident. The slowdown in inflation, from over 11% in the second quarter of 1982 to 9.3% at year-end gave a boost to consumer confidence according to Canada's Conference Board, suggesting consumers may be in a better buying mood. In addition, the decline of interest rates has spurred a revival of housing starts. The unemployment rate—which has been above 12% since last August and peaked at 12.8% in December—dropped to 12.4% in January. Not all indicators are positive; business profits and export orders, for example, have yet to confirm that the rebound is unquestionably underway. Nevertheless, with a moderate recovery expected for the U.S. economy, the emerging trends that have already surfaced in Canada suggest a rise in real GNP this year in the neighborhood of 1.5%—a marked turnaround from the 5% decline of 1982.

Oil price uncertainties suggest another year of sluggish growth for Venezuela.

The Venezuelan economy grew by a scant 0.4% in real terms last year as petroleum export earnings fell because of both price and volume declines. This represented the fourth consecutive year of sluggish economic activity owing to either policy-determined demand restraints or flagging oil earnings. The drop in 1982 demand prompted a slowdown of inflation but also a rise in the unemployment rate to 7%. Prospects for the economy in 1983 are heavily dependent on the course of international oil prices and Venezuelan output. Petroleum production in the first three weeks of January was at 2.1 million barrels per day—11% higher than the 1982 average rate. But lingering price uncertainties will inevitably affect export earnings this year. The efforts now underway to refinance the short-term portion of Venezuela's $24 billion public-sector external debt could also add to possible difficulties. In view of these considerations, policy officials appear to be maintaining their restrictive stance of the recent past. This is likely to mean another year of slow economic growth.

Constraints on external funding limit growth in Bangladesh.

The external funding constraint will be the critical force governing the performance of the Bangladesh economy over the next several years. The government has largely exhausted its ability to insulate the economy by running down foreign reserves, and economic activity must now adjust to the level of imports that can be financed from aid inflows, export receipts, and private transfers. Given the outlook for these three sources, imports will have to be constrained for some time to come. This will have serious repercussions for domestic growth, particularly in the non-agricultural sectors. In the current fiscal year 1982-83 (which ends June 30), unless unanticipated capital inflows are forthcoming, the government will have to hold imports down some 3.4% below the already depressed level of 1981-82. This is likely to lead to a drop of manufacturing output of about 4%. As a result, despite the likelihood of a modest rebound in agricultural production this fiscal year, real growth is projected to be just 2%.

Bahrain rides out recession.

For some time Bahrain, with its low and declining oil production, has been preparing itself for a post-petroleum era. In the 1970's it emerged as the service center of the Arab Gulf region and more recently it has been investing heavily in industrial projects based upon its natural gas resources. As a result, Bahrain has so far been able to weather the current oil glut better than some other oil producers. The world recession is taking some toll: Weak demand has forced production cutbacks at both the oil refinery and the aluminum smelter. On the whole, however, domestic economic activity has remained brisk, mainly because a number of new large infrastructural and industrial projects—including the $560-million 26-kilometer causeway between Bahrain and Saudi Arabia—have commenced construction. Bahrain's strong financial position, appears to have remained inact as oil output from its domestic field and from the Abu Saafah field shared with Saudi Arabia has shown little deviation from previous levels. Meanwhile, Bahrain's offshore banking sector has continued to prosper, with some 68 offshore banking units now licensed. As of the end of 1982's third quarter, their total assets had reached $59.5 billion—28% above the level a year before.

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The 1984 Budget: The More Things Change . . .

The Reagan administration's fiscal 1984 budget proposal repeats many of the themes from its budget proposal for the last fiscal year: promoting economic growth and preserving the gains made in reducing inflation, while at the same time diminishing the magnitude of the deficits. The multi-year tax cuts approved in 1981 are to be preserved, and the planned defense buildup is to remain essentially intact as well. And with economic growth prospects projected to be less sanguine than was expected a year ago, Congress faces yet another round of spending cuts and tax increases to meet the continuing challenge of extremely large deficits.

Many legislators thought that the deficit problem had been adequately addressed by last year's reconciliation bill, which included both expenditure reductions and revenue-raising measures. A year ago, the fiscal-1983 deficit had been projected to be $146 billion, with deficits in later years averaging $170 billion if no legislative actions were taken. The administration proposed enough spending cuts and tax increases so that the 1987 gap would narrow to $53 billion from $91 billion in 1983. Despite congressional acceptance of about 70% of these proposals, however, the Office of Management and Budget estimates that the 1983 deficit will now be $207 billion. And the OMB projects that the gap could widen to more than $300 billion in 1987 unless further spending cuts or tax increases are enacted.

The estimated budget deficits have soared primarily because of a substantial downward revision in economic-growth prospects. Last year's budget projected real growth of 3.0% during 1982 and 5.2% in 1983. But real GNP actually declined 1.2% in 1982, and 1983 growth is forecast to be just 3.1% in the budget. This six-percentage-point difference by year-end 1983 would lead to a reduction of $69 billion in estimated tax receipts for fiscal 1983. Lower-than-expected inflation would also contribute to this revenue shortfall. Meanwhile, spending estimates have been raised by nearly $50 billion—in large part because of such recession-induced expenditures as unemployment compensation.

In an effort to maintain control over the budget, the President's 1984 budget proposal aims specifically at trimming the projected 1987 deficit by more than half the OMB projection, to $142 billion. The centerpiece of the plan is a freeze on overall government spending in real terms. Allowing for inflation, actual expenditures would rise only 5.4% in fiscal 1984. This would come on the heels of spending increases of an estimated 10.5% in fiscal 1983, 10.8% in fiscal 1982, and 14% in fiscal 1981.

Political opposition to the spending restraint is likely to be high, however, particularly because of the extremely uneven impact on different spending categories. For example, a 16% increase in interest outlays and a 14% increase in defense spending are to be offset by halting growth in income security programs and the broad residual category that encompasses all other federal programs.

Although overall spending is proposed to increase slightly faster in later years, the budget recommends maintaining the same pattern of relative rates of increase. Thus, by 1988, the share of government spending going for defense would rise to 34.2% from 25.7% in fiscal 1982, while the income-security share would fall to 27.5% from 30.4%. The interest burden would remain steady, while the budget share for all other items would fall to 26.4% from 32.3%.

In light of the relatively pessimistic economic assumptions used in the budget, the actual performance of the economy will be a key influence on the fate of the President's proposals. If growth indeed turns out to be as slow as the administration projects, Congress might be reluctant to go along with the proposed restraint of spending. Sentiment is already building to increase spending on some direct job-related measures, such as training programs. The President himself has proposed an additional six months of extended unemployment benefits.

On the other hand, a more rapidly improving economy would ease some of the pressure both to stimulate the economy and to reduce the deficit. For example, if real growth should rise 5% this year rather than the projected 3%, the fiscal 1983 deficit would fall by about $30 billion to $180 billion, with even greater improvement in fiscal 1984.

Of course, there are less-pleasant surprises that could enlarge the deficit. For example, falling oil prices would reduce revenues from the windfall-profits tax and the oil-rights leasing program. Or another year of bumper crops could drive up the cost of agricultural subsidies.

Especially facing such risks, a stronger economy would be a more welcome way of reducing the deficits than the spending curbs and tax increases that have been proposed so far. The consensus of private forecasters seems to be shifting toward the view that this faster growth will indeed occur. Even with six years of uninterrupted growth averaging 4% per year, however, the fiscal 1988 deficit would remain over $100 billion. Unemployment is then projected to be down to 6.2%—the lowest rate of unemployment the administration thinks is attainable without inflation pressures reemerging.

While deficits of this magnitude in the context of a prolonged recession are not necessarily inflationary, the prospect of such a large budget gap when the economy's resources are nearer full-employment levels is clearly disturbing to many credit-market participants—and to governors of the Federal Reserve Board. Since the Reagan administration seems content with stabilizing inflation in the 4%-5% range, the burden of any further progress in the anti-inflation fight has fallen on the shoulders of the Fed. *Douglas L. Bendt*

The U.S. Economy

Asia and Oceania Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE OF PAYMENTS						MONEY AND BANKING						COUNTRIES
			6 months ending	12-month change	in billions of dollars	$ per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes: latest data	12-month changes: consumer prices	12-month changes: latest data	12-month changes: money supply(M1)	exchange rate in U.S. dollars, February 9, 1983	change from year earlier, February 9, 1983	current monetary conditions	
Asia	Bangladesh	Government austerity measures depressing nonagricultural activities.	Sept.	+ 3%	10.8*	120	Dec.	183	+ 32%	1.0	413	External resource constraint will necessitate 3.4% cut in FY 1982-83 imports.	Nov.	+ 5%	Sept.	+ 6%	.0408	−20%	Credit demand sluggish; taka depreciation resumed.	Bangladesh
Asia	Burma	Goverment claims real growth of 7% likely in year ending March 31.	Aug.	−15%	5.8*	159	Dec.	89	− 61%	2.6	79	IMF loan of $27.9 million received to compensate for export shortfall.	Aug.	+ 8%	Feb.'81	+12%	.1267	− 6%	Exchange rate remains fixed against SDR.	Burma
Asia	China, People's Republic	Industrial growth of 7% and record grain harvest expected in 1982.	Dec.	+ 3%	260.0	260	Sept.	9,444	+140%	6.7	492	Import growth accelerating after record trade surplus of $4.6 billion in 1982.	Dec. '81	+ 3%	Sept.	+12%	.5120	− 8%	Investment growth to boost deficits in 1983.	China, People's Republic
Asia	Hong Kong	Real GDP will probably grow by a modest 6% this year.	June	+ 7%	24.2	4,695	n. a.	—	—	—	—	Most recent statistics indicate trade deficit narrowing owing to import declines.	Sept.	+ 9%	July	+ 6%	.1508	−12%	Interest rates falling fast.	Hong Kong
Asia	India	Bombay textile strike enters second year.	Aug.	−15%	161.4*	236	July	4,524	− 16%	4.4	2,279	India will be major beneficiary of any reduction in oil prices.	Oct.	+ 7%	April	+ 9%	.1002	− 9%	Credit remains restrictive.	India
Asia	Indonesia	Oil-fueled real growth slows; austerity measures likely.	July	−23%	81.5	541	Dec.	3,145	− 37%	2.5	0	Falling oil revenues hurt current account, putting pressure on rupiah.	Oct.	+ 9%	Aug.	+27%	.0014	−13%	Foreign reserves dropped about $2 billion in 1982.	Indonesia
Asia	Japan	Economy remains sluggish; still no clear signs of recovery.	Nov.	−13%	1,130.3	9,607	Dec.	23,334	− 17%	2.3	0	Current account surplus of $6.9 billion recorded in 1982.	Nov.	+ 2%	Oct.	+ 8%	.00419	− 1%	Yen weakness forestalls discount rate cut.	Japan
Asia	Korea	Government projects real growth of 7.55% in 1983, with a 12% rise in exports.	Nov.	+ 1%	62.3	1,610	Dec.	2,807	+ 5%	1.4	1,259	Export growth slowed in 1982; exports only $22 billion.	Dec.	+ 5%	Oct.	+68%	.0013	−13%	Money supply target 20% this year.	Korea
Asia	Malaysia	Additional fiscal belt-tightening likely.	July	+ 6%	24.0	1,665	Nov.	3,893	− 1%	3.6	274	First LNG shipment left Malaysia for Japan.	Sept.	+ 5%	Oct.	+14%	.4385	− 1%	Budget deficit for 1982 soared to 19% of GNP.	Malaysia
Asia	Pakistan	Real growth around 6% projected in fiscal 1982-83 ending June 30.	Sept.	−13%	30.9*	360	Dec.	969	+ 34%	2.1	1,165	December exports up 32% over year-ago in rupee terms but only 3% in dollars.	Nov.	+ 4%	Oct.	+16%	.0781	−22%	Steel mill will take large chunk of planned credit.	Pakistan
Asia	Philippines	Real growth for 1982 estimated at 2.6%, the lowest rate in 20 years.	Sept.	− 9%	38.6	780	Dec.	1,720	− 22%	2.5	833	3% ad valorem tax, prepayment of customs duties adopted to cut imports.	Oct.	+11%	Oct.	− 1%	.1080	−11%	Ceiling on foreign borrowing trimmed to $2 billion.	Philippines
Asia	Singapore	Real GDP growth projected to be a sluggish 2%-3% in 1983.	Oct.	0	12.5	5,121	Sept.	7,633†	+ 12%	3.3	0	Exports down owing to world recession.	Nov.	+ 1%	Sept.	+17%	.4803	+ 1%	Interest rates falling steadily since mid-1982.	Singapore
Asia	Sri Lanka	Announcement of 1983 budget awaited, expected to give direction of economic policy.	Oct.	− 6%	4.4	294	Nov.	287	− 5%	2.0	377	Tea prices continue to recover.	Oct.	+ 8%	Sept.	+18%	.0467	− 1%	Mahaweli project pressuring budget, credit expansion.	Sri Lanka
Asia	Taiwan	Recently signed agreement with U.S. will permit modest expansion of textile industry.	Sept.	+ 3%	46.0	2,559	Sept.	7,897	+ 51%	5.1	0	Restrictions on imports of Japanese goods have been lifted.	Sept.	+ 2%	Sept.	+21%	.0141	−51%	Loan rates fell about 400 basis points in 1982.	Taiwan
Asia	Thailand	Central bank puts 1982 real growth at 4.5%, forecasts 5.5% for 1983.	Sept.	− 3%	36.1	750	Dec.	1,538	− 11%	2.1	702	Volume declines in agricultural products will make export gains difficult.	Nov.	+ 4%	June	+ 6%	.0450	− 1%	Rate ceiling on loans cut to 17.5% from 19%.	Thailand
Oceania	Australia	Real GDP expected to fall 2% in year ending March 31; drought halved wheat crop.	Sept.	0	158.2	10,648	Dec.	6,371	+281%	2.8	36	Capital inflows in 1982 second half net new record of A$6.33 billion.	Sept.	+12%	Oct.	− 1%	.9650	−12%	Interest rates fall fast as foreign capital pours in.	Australia
Oceania	New Zealand	Further declines in business activity expected before the economy bottoms out.	Oct.	− 1%	23.5	7,510	Dec.	664	− 1%	1.3	3	Exports have fallen because of low demand for agricultural products.	Sept.	+17%	Oct.	+ 2%	.7120	−10%	Interest rates have remained high, bucking world trend.	New Zealand
Oceania	Papua New Guinea	Depressed business conditions contribute to government's decision to trim its workforce by 10%.	Sept.	−10%	2.6**	867	Dec.	345	− 24%	3.4	50	Rising copper prices will help to improve the current account.	Sept.	+ 6%	Sept.	− 5%	1.3425	− 6%	Falling Australian interest rates should ease credit conditions.	Papua New Guinea

*Fiscal year **1980 †includes gold holdings

World Interest Rates

market rates of Feb. 8, 1983; bond yields as of Feb. 4, 1983

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	8.50	9.99	11.00 intervention rate	11.50	9.50	6.00	18.00 penalty rate 21.00	4.50	4.50	5.50
Day-to-Day Money	8.375 February 9	9.75	11.00	9.45	12.563	6.00	19.00	5.00	3.00 1-month Euro-Swiss fr. rate	6.688
Treasury Bills 91-day, Middle Rates	8.55	9.55	10.75	12.25	n. a.	n. a.	18.004 78 days	no dealing	no market	n. a.
Commercial Paper prime, 3-month, asked	8.75 finance paper discount basis	9.80 finance paper 15% tax w/h	n. a.	11.40 Certified	13.00 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.50	9.75 15% tax w/h	10.875	11.40 Certified	not traded	6.50	19.25	no market	3.1875	no market
Government Bonds Long-term, new and old issues, average yield	11.00	12.41	11.70	10.72	14.39	7.95	19.43	7.89	4.23	7.43
Industrial Bonds prime, long-term, new and old issues, average yield	12.00 Aa Industrials	13.375	12.90	13.20	15.11	8.30	19.27	8.23	5.85	6.39
Bank Short-Term Rate (prime rate)	11.00	12.00	11.00	15.50	14.55	9.00	20.00 ⅛ qtrly fee on outstdng.	7.00	8.00	6.00
Bank Time Deposits 3-month	8.375 Cert. of Dep.	8.50	11.25	12.15	13.00	6.00	11.50	4.875 large deposits	2.00 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	9.438	10.00	11.313	no market	21.375	5.875	no market	5.00	3.25	6.75
Exchange Rates—in U.S.$ rates floating against the $	—	.8164	1.5415	.0209	.1449	.4111	.0007	.3731	.4965	.0042
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.441 *D*	1.583 *D*	4.221 *D*	11.318 *D*	3.503 *P*	12.80 *D*	4.503 *P*	6.284 *P*	2.554 *P*

Eurodollar Deposits (London, interbank, bid) February 9

7-day	8.750
1-month	8.875
3-month	9.250
6-month	9.563

International Arbitrage (3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−0.470
U.S.-Canada Treasury Bills	−0.209
U.S.-Canada Finance Co. Paper	−0.475
Eurodollars-U.K. Local Auth. Deposits	+0.083

Eurobonds (average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	11.25
Over 7 yrs.	11.50
DM Bonds	
7 yrs. and under	7.75
Over 7 yrs.	8.00

Gold Price

London afternoon fixing

497.25 (pr. fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate (prime rate), while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(Dec.) 3.9	(Dec.) 9.3	(Dec.) 5.4	(Dec.) 9.4	(Jan.) 3.9	(Jan.) 16.4	(Dec.) 5.5	(Dec.) 1.8
Industrial production*	(Dec.) −6.1	(Nov.) −11.6	(Nov.) −0.6	(Nov.) −1.5	(Dec.) −4.8	(Nov.) −7.5	(June) −0.7	(Dec.) −0.3
Trade balance† *(billions of local currency units)*	(Dec.) −$3.37	(Dec.) C$1.80	(Dec.) £0.59	(Dec.) −FF5.9	(Dec.) DM6.39	(Dec.) −Lit.1.13	(Dec.) −SF0.23	(Dec.) ¥582.1
Money supply (M1)*	(Dec.) 8.1	(Oct.) 5.4	(Oct.) 18.8	(Aug.) 15.0	(Oct.) 6.5	(Aug.) 13.5	(Oct.) 7.2	(Sept.) 5.0
Velocity of money (M1)*	(Dec.) −8.0	(June) 1.5	(March) −5.1	(June)** 1.2	(June) 1.2	(June)** 7.6	(March)** −5.8	(June) −1.4
Reserves minus gold *($ million, change from previous month)*	(Dec.) −60	(Dec.) 113	(Dec.) −671	(Dec.) 3,182	(Dec.) 1,262	(Dec.) 861	(Dec.) 1,729	(Dec.) 338

* Percent change from 12 months earlier. ** based on GDP. † Figures are only for the month indicated.

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Tough Choices Ahead for Portugal

Portugal is about to be given yet another chance to come up with a political alliance that can deal effectively with its economic problems. Earlier this month, President Eanes—in an effort to fill the political vacuum left by the breakup of the right-of-center Democratic Alliance under Prime Minister Balsemao—dissolved Parliament and called for a general election to be held on April 25.

Whatever the outcome of the election, the winners will be faced with tough decisions on economic policy. Developments over the past two years have caused some of the optimism over Portugal's medium-term growth potential to fade. In general, long-term prospects are still viewed as good—especially given expectations of future membership in the European Economic Community (EEC). But there are growing concerns that without rapid attention to the need for both short-run stabilization measures and fundamental structural reforms, the country's economic potential may not be fully realized.

Portugal had begun a program of economic stabilization in 1977, and by the end of the decade it was starting to show some success, raising hopes that the economic dislocations of the 1974 revolution would soon be history. The election of the Democratic Alliance in 1979 saw a move toward economic liberalization. Under then-Prime Minister Sa Carneiro, the coalition seemed determined to address the country's long-term problems. Since then, however, the Portuguese economy has faltered in the face of the second oil price shock, world recession, and delays in dealing with a number of important economic issues.

A disappointing 1982

Prospects for the economy in 1982 were never bright, but initially there was some promise that the year would at least bring some improvement over 1981's record: The 1982 budget called for reducing the deficit as a proportion of GDP to 8.6% from 11.4% the year before; accordingly the government initiated a hiring freeze and raised expenditure taxes. Reports had indicated that a three-year Extended Fund Facility agreement to provide $1 billion toward structural improvements had been negotiated with the IMF. The crippling drought of 1981 had finally come to an end. And since a modest world recovery was expected, the authorities anticipated a reduction in the current-account deficit from 1981's $2.7 billion—an unwieldy 12.4% of GDP—and a moderate rebound from the 1.8% real growth of the previous year.

Policymakers' hopes for the year were never realized. In part, this was due to forces beyond their control: World trade, including tourism, remained depressed; high interest rates continued to impose a burden; and rainfall increased but was insufficient to refill Portugal's reservoirs.

Some of the responsibility for last year's poor economic performance, nevertheless, stems from domestic sources. The agreement with the IMF that would have imposed corrective measures was not finalized. Furthermore, government finances failed to improve as budgeted. Unofficial estimates place the 1982 deficit at 180 billion escudos—still roughly 10% of GDP. Consumer price inflation by year-end had slowed significantly from its 27.1% peak last March. But at more than 20%, it was still the highest in Europe. Economic growth is estimated to have picked up only slightly, to around 2%.

The government did take some deflationary policy actions. For example, monetary policy was tightened in April and the escudo was devalued by 9.3% in June in an effort to stem import growth. But these measures were insufficient to prevent a further deterioration of Portugal's balance-of-payments position. Export volume in 1982 is estimated to have risen by only 4%, well below the officially forecast 7%. And both worker remittances and tourism receipts—two important sources of foreign exchange—fell below their 1981 levels. As a result, the current-account deficit swelled to around $3 billion—more than 13% of GDP.

A pivotal year

Portugal's economic condition will become of concern if the current-account deficit is not reduced. The old government had aimed for a reduction in the current-account deficit in 1983 to a still-high, but somewhat more manageable, $2 billion. However, the current economic environment will not make this easy to achieve. With much of the world—particularly Europe—still in recession, demand for Portuguese exports will not be strong. And without further adjustment of the escudo, the competitiveness of the country's exports will deteriorate still further. Tourism and remittances are likely to be similarly weak. However, debt-servicing costs should decline as the fall in U.S. interest rates will more than offset the effect of any increase in external debt. The crucial question will remain the strength of import demand. Without strong deflationary measures, imports will continue to rise. Renewed expansionary monetary and fiscal policies would almost certainly preclude any substantive near-term improvement in the current-account balance.

To an extent, concerns over the increase in Portugal's current-account deficit have been somewhat

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overstated. Prior to the revolution, Portugal had virtually no external debt. It thus has had some room for prudent, moderate borrowing. Moreover, as a result of historical developments, the country holds over 22 million ounces of gold in its reserves. This is currently worth some $11 billion at market prices and largely offsets its stock of debt.

The gold, however, does not generate a flow of income to mitigate the burden of a debt that has to be serviced at market rates. Furthermore, although Portugal's net foreign liabilities are comparatively low, there is a danger that they will grow quite rapidly unless the deficit is sharply reduced. In all likelihood, the success of the new government's efforts to shrink the balance-of-payments gap will be judged as a short-run indicator of its policymaking abilities.

Structural reforms

To fulfill the positive medium-term outlook, the Portuguese authorities must also quickly come to grips with the country's structural problems. Important issues concerning public finance, industrial restructuring, and agricultural reform need to be resolved if high growth rates are to be restored, if the balance of payments is not to be excessively constraining, and if Portugal is to take full advantage of future EEC membership.

At about 10% of GDP, before allowing for the borrowing of public enterprises, Portugal's large government deficit is a continuing drain of economic resources and a generator of inflation. This is of concern because the deficit is, to a large extent, financing consumption expenditures rather than public-sector investment. One of the major causes of the burgeoning budget gap has been the rapid escalation of public subsidies. Cutbacks will be required if the government's financial position is to be improved in order to alleviate Portugal's external-financing constraint.

Furthermore, as long as the public deficit remains large, policymakers will be hard-pressed to bring down inflation significantly. The lack of effective domestic capital markets has meant that the deficit has been financed almost totally by the Bank of Portugal's money creation. For example, in 1981, the needs of the general government and public enterprises accounted for 47% of domestic credit creation. Any attempt to reduce inflation via the control of money or credit will inevitably crowd out private borrowers unless public borrowing requirements are reduced.

The industrial sector needs to perform strongly if Portugal's economic future is to be assured. At present, industry generates some 39% of GDP and 70% of merchandise exports. It has been among the leading sources of growth in the last decade and still has the ability to continue to play this role. But for this to happen, strong actions are required: new products should be introduced; more efficient production techniques must be adopted, particularly in the textile, engineering, ceramic, and footwear sectors; and nonviable plants need to be phased out. Moreover, the government will need to reassess the currently large public investments and subsidization of heavy industries. The most crucial requirement, however, is a reexamination of government price controls and other regulatory measures.

Portuguese agriculture has the reputation of being among the least developed in Europe. Although it suffers from low and sporadic rainfall, the sector's long-term potential offers large output gains from the use of better techniques and more fertilizer.

The medium-term agricultural outlook centers around the EEC. While the future of the Community's Common Agricultural Policy (CAP) is uncertain, it is clear that EEC membership will bring to Portuguese farming a new pricing structure, new institutional support measures, different protection, and a greater access to EEC markets. Cereals and dairy products are likely to be adversely affected, but there are good prospects for tomatoes and other fruits, wines, and forestry products—despite the likelihood of Spanish competition. As a result, Portugal has the ability to benefit from the CAP, although this will require an aggressive response to the opportunities that will be provided. Output structure must be changed, producers' associations must be strengthened, and more government resources must be devoted to extension and agricultural guidance.

Progress during 1983 will be an important guide to the future of Portugal. The country's low wages and low unit labor costs and its strategic geographical position—along with the ability its exporters have shown in the past to respond to the incentives of new markets and enhanced competitiveness—all argue that the country has good potential for medium-term growth. However, there is a need for the implementation of a strong economic policy that will enable that potential to be realized. The biggest challenge to Portugal's new government will be to act quickly in order to restore the vigorous performance the economy has the ability to achieve.

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